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No. 96-1486

In the Supreme Court of the United States

OCTOBER TERM, 1996

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF ROSE D'AMBROSIO, DECEASED,
VITA D'AMBROSIO, EXECUTRIX

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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1. The court of appeals candidly and correctly acknowledged that its interpretation of the controlling estate tax provisions squarely conflicts with the decision of the Federal Circuit in *Gradow* v. *United States*, 897 F.2d 516 (1990), aff'g 11 Cl. Ct. 808 (1987). See Pet. 7-10. The court explained that (Pet. App. 11a):

> [W]e cannot agree with the *Gradow* court's conclusions that "property" refers to the fee simple interest and that adequate consideration [for purposes of 26 U.S.C. 2036(a)] must be measured against that value.

Respondent errs in claiming that this conflict need not be resolved simply because the conflicting appellate decisions under Section 2036(a) "involved transactions that are factually distinct from the sale of a remainder interest presented in the instant case" (Br. in Opp. 14). As the court of appeals noted, the issue of statutory interpretation presented in this case occurs in numerous factual contexts, for "techniques for attempting to reduce estate taxes are limited only by the imagination of estate planners, and * * * new devices appear regularly" (Pet. App. 13a). The fact that the reported appellate decisions have addressed this legal issue in a variety of factual contexts emphasizes the broad and recurring importance of the question presented.

As the court acknowledged in this case, the circuits have disagreed as to the proper meaning and application of Section 2036(a). See Pet. 15-18; Pet. App. 11a. Professional advisors, on whom taxpayers necessarily rely in making estate planning decisions, have expressed the same uncertainty and disagreement. See Pet. App. 18a-19a & n.3; *id.* at 30a-31a ("Numerous articles have been written on this issue, and the legal commentators debate its resolution."). In the absence of review by this Court, and in the face of this continuing uncertainty, taxpayers will be unable to determine with reliability the consequences of the estate planning choices that they are to make. This is unfair to taxpayers, for errors in estate planning cannot be corrected after the taxpayer's death.

2. Respondent errs in asserting that resolution of this conflict among the circuits is unnecessary because the "issue in the instant case is not frequently litigated" (Br. in Opp. 13). As respondent concedes (*ibid.*), four of the courts of appeals have now

had occasion to address the question presented in this case. Moreover, as the petition notes, two additional cases presenting this same legal issue are presently pending in other circuits (Pet. 24). The fact that the Third Circuit, in the present case, has created a conflict among the circuits on the proper interpretation of Section 2036(a) will plainly increase even further the volume of such litigation. New estate planning devices "appear regularly" before the courts (Pet. App. 13a) precisely because of the recurring interest of taxpayers and estate planners in circumventing or limiting the effect of existing estate tax provisions.

3. Respondent also errs in claiming that review is unnecessary because "new laws" (Br. in Opp. 11) have eliminated the abuse that the decision in this case would permit.

a. The court of appeals erred in suggesting that 26 U.S.C. 2701, which was added to the Code in 1990, resolves future concern over "abusive transfers of remainder interests" (Pet. App. 14a n.2). As we explain in the petition, and as respondent acknowledges, that statute addresses only "transfers involving interests in business entities" (Br. in Opp. 12). It does not generally address abusive transfers of remainder interests of the type involved in this case. See Pet. 21-22 n.13.

b. Respondent nonetheless claims that 26 U.S.C. 2702—a provision *not* cited by the court of appeals—"addresses transfers of all types of property" (Br. in Opp. 13) and thereby diminishes the continuing importance of the issue presented in this case. That contention is not correct.

Section 2702 addresses only the application of the *gift* tax to transfers covered by that Section. The

rules established in Section 2702 are "*[s]olely* for purposes of determining whether a transfer * * * is a gift" and, if so, "the value of such transfer" (26 U.S.C. 2702(a) (emphasis added)). By contrast, the rules of Section 2036(a), which the present case involves, are solely for the purpose of determining "[t]he value of the gross estate" for purposes of the *estate* tax (26 U.S.C. 2036(a)). Whether or not a gift tax is imposed at the time of the transfer (under Section 2702), an estate tax will result at the time of death (under Section 2036(a)) if the transferor "retained for his life * * * the possession or enjoyment of, or the right to the income from, the property" (26 U.S.C. 2036(a)(1)). The rules of these two Sections of the Code supplement each other. They do not displace each other.*

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* As noted in the petition (Pet. 21-22 n.13), a transfer of a remainder interest to a family member, with a life estate retained by the transferor, would trigger an immediate gift tax for the amount by which the value of the property exceeds the value of any consideration received from the transfer. In calculating the amount of this imputed gift, Section 2702 establishes a prophylactic rule under which *no* value is attributed to the retained life estate unless it is in the form of a "qualified interest" (26 U.S.C. 2702(a)(2)(A)), a term that generally refers to a right to receive a fixed, periodic payment (26 U.S.C. 2702(b)(1)). If a gift tax were required under the prophylactic rule of Section 2702, that would not remove the transfer from the coverage of the estate tax under Section 2036. Similarly, if a gift tax were *not* paid (because the tranferor retained a "qualified interest"), that too would not remove the transfer from the coverage of the estate tax. Section 2702 does not repeal Section 2036. The Code specifically contemplates that transfers to which the gift tax has applied may be "pulled back" into the estate and subjected to the estate tax; double taxation is avoided by the credit available

As several commentators have noted, property in which the transferor retains a life estate is "included in the gross estate of the transferor [under Section 2036(a)], regardless of whether Section 2702 applied to the original transfer." R. Stephens, S. Lind, G. Maxfield & D. Calfee, *Federal Estate and Gift Taxation* ¶ 19.03[4][c], at 19-120 n.322 (7th ed. 1997). If the retained "life estate is not subsequently gifted and the transferor dies, the property generating the income interest would be pulled into the tranferor's gross estate under Section 2036." *Id.* at 19-119 to 19-120. See also J. Blattmachr & A. Painter, *Planning for Split-Interest Transfers Under the Section 2702 Final Regulations*, 240 PLI/Est 103, 108 n.20 (1995); note *, *supra*.

The enactment of Sections 2701 and 2702 has not lessened the interest of practitioners in devising means of avoiding the estate tax imposed under Section 2036. The professional literature burgeons with discussions addressing that objective. See,

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under the estate tax for any gift tax paid in connection with the transfer. 26 U.S.C. 2001(b); see 26 U.S.C. 2012(a).

Even in the limited situations in which a gift tax is applied to the transfer under Section 2702, the value of the taxable transfer is different under the gift and estate tax: the estate tax reaches the value of the property on the date of death (26 U.S.C. 2043(a)); the gift tax is instead calculated on the value of the gift on the date the gift is made (26 U.S.C. 2512(a)). The estate tax thus captures the accretion of value occurring after transfers of a testamentary nature are made in the guise of *inter vivos* dispositions of "remainder" interests in property. See M. Neumann, *Estate Freeze Techniques Outside of Chapter 14*, 2 NYU Proceedings of the Fifty-Third Institute on Federal Taxation ¶ 21.08[1][b], at 21-39 (Matthew Bender 1995) ("the Grantor's gross estate will include the entire fair market value of the property * * * as of the date of the Grantor's death").

e.g., W. Scanlan, Jr., *GRITs, GRATs & GRUTs: A Phoenix Rises From the Ashes of Section 2036(c)*, The Twenty-Seventh Annual Philip E. Heckerling Institute On Estate Planning ¶ 1409.3, at 14-29 (Matthew Bender 1993); P. Schneider, *Section 2702 or GRITs, GRATs and GRUTs (What Does Your Client Want?)*, The Twenty-Sixth Annual Philip E. Heckerling Institute On Estate Planning ¶ 1204.6, at 12-45 (Matthew Bender 1992). Respondent is thus simply incorrect in contending that "new laws" relating to the *gift* tax implications of *inter vivos* transfers of remainder interests have "effectively eliminated" (Br. in Opp. 13) the *estate* tax issues relating to such transfers under Section 2036. To the contrary, as the commentators cited above have noted, these "new laws" neither address nor resolve the recurring *estate* tax issues under Section 2036(a). See also note *, *supra*.

4. It is a common "Federal estate planning technique" to employ an *inter vivos* transfer of remainder interests in an effort "to remove the value of property from Decedent's gross estate" (Pet. App. 30a). Prior to the decision in this case, the courts had consistently held that such transfers are ineffective to accomplish that goal unless the decedent received, in return, property of equal value. By disagreeing with that uniform view, and by creating a conflict among the circuits on the proper interepretation of Section 2036, the decision in this case creates pervasive uncertainty for taxpayers and tax planners—and for the administration of the estate tax.

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For the reasons stated above and in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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Acting Solicitor General

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